ECONOMIC LACKS OF BALANCE AND THE POLICIES OF ADJUSTING TO THE SHOCKS OF AGGREGATED DEMAND AND OFFER

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ABSTRACT: *The paper draws out an analysis of the manners of adjusting economy to a shock that affects aggregated demand and offer. The adjusting manner is implemented according to specialized works on the basis of classical monetarist conceptions and Keynes's conception. At the same time, in order to influence aggregated demand and offer monetary, fiscal, and budget policies are employed.*

KEY WORDS: *aggregated demand, aggregated offer, labour market and goods and services market balance, adjustment to the values of demand and offer, unfavourable shock upon offer*

In order to analyze certain significant aspects of *adjusting to the values of aggregated demand*, we have started from the graphic representation in figure 1. We can notice that there is an ascending short term aggregated offer (OA_{CS}) as well as a vertical long term offer (OA_{VL}). We start from the hypothesis that economy which witnesses a general balance of a complete use of labour is located in point A; it suddenly faces a decrease of aggregated demand, from CA_0 to CA_1; as a result production decreases from y_0 to y_1, and prices from P_0 to $P_{1;}$ in point B we witness an under-using of labour that determines the decrease of jobs, and, consequently, unemployment.

Specialized economic works display several manners of adjusting to the values of aggregated demand, according to the classical, monetarist, and Keynes's conceptions. *According to the classical conception,* the coming back to economic balance is automated and instant. Relying again on figure 1, we consider that the movement is done along the vertical long term aggregated offer. Accordingly, the excess of offer on the goods and services markets has as a result the decrease of prices until demand is in balance with production, a fact that corresponds to a complete use of labour. As a result, in case prices decrease to P_2, the new balance settles in point C.

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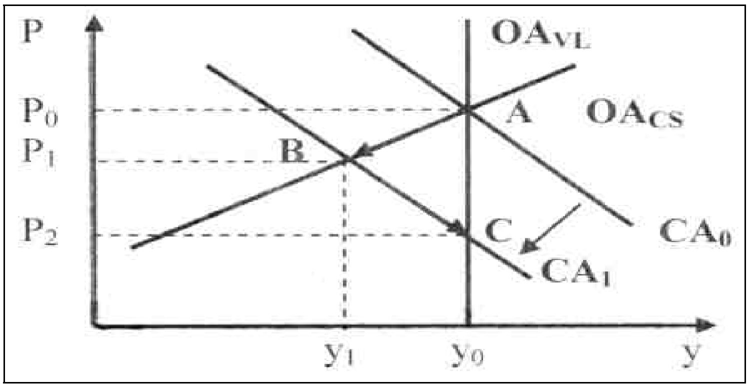

Figure 1. Representation of adjusting to the shocks of aggregated demand

During the adjustment process the diminishing of production and jobs are not stimulated. *According to the monetarist conception,* on a short term, offer increases, and the decrease of aggregated demand moves economy from point A to point B; the fact is explained by the poor flexibility of prices and salaries. Taking into account the new aggregated demand, a constant amount y_0 can be retailed only in case price drops in P_2 that is in point C.

Nevertheless, on a short term, prices cannot decrease to such an extent. Producers do not agree to offer the same amount as in the past to a lower price as the decrease of selling prices increases the real production cost. In case producers could compensate price decrease owing to a decrease of nominal salaries, the real production cost would be constant and they would accept to manufacture y_0 at price P_2.

Yet, it is known that nominal salaries are not entirely flexible as regards their diminishing, and, on a short term, the workers do not correctly anticipate the diminishing of existing prices. As a conclusion, we consider that *each diminishing of the salary reflects, for the workers, a diminishing of their buying capacity; as a result, they refuse to accept a diminution of salaries, the employers being obliged to reduce jobs and production as a result of the increase of labour real cost.*

In figure 1, point B is not a long term balance point; owing to the free action of adjustments, economy is going to direct towards the complete use of labour. In point B here is unemployment, yet, the competition among workers results in the pressure exerted upon nominal salaries regarding their diminution, and they adapt their anticipations to the new data regarding the prices. To the extent they acknowledge the diminution of existing prices and more accurately anticipate the effective level of prices, the employees more easily accept the diminution of nominal salaries in order to maintain their jobs or to find a job in case they are unemployed.

The gradual diminution of nominal salaries allows the increase of the number of jobs and of production as well as the decrease of prices in order to retail increasing offer. Accordingly, the curve of short term aggregated offer moves towards right. The diminution of salaries and prices continues as long as there is an under-use of labour, the economy moving to point C where it is going to reach the complete use of labour. In this point, salaries and prices have equally decreased, labour real cost being identical with that in point A, and the degree of labour employment returns to its initial level. As a conclusion, we consider that unemployment is especially due to the stiffness that intervenes in negotiating salaries; it is only temporary associated with data asymmetry and anticipations.

Classical and monetarist logic differ regarding the length of the adjusting process; nevertheless they have the same vision regarding its nature. We deal with the following mechanism: *prices' diminution brings demand to its initial level, a fact that allows the retail of a production that corresponds to a complete use of labour; the unemployment that accompanies recession determines the decrease of nominal salaries; the decrease of nominal salaries allows the producers to diminish prices and re-establish the degree of labour employing and the level of production.* Keynes's conception contests the efficacy of these mechanisms, stating that the balances on labour market and on the goods and services market cannot be restored automatically. On the one hand, salaries diminishing do not necessarily occur, and when they occur they are not enough in order to make unemployment disappear.

On the other hand, salaries diminishing do not always allow a sufficient diminution of prices in order to restore an insufficient aggregated demand. Keynes states that it is normal for the workers to resist productivity decrease as long as they consider that the individuals who do the same work have an unchanged salary. The modern theories of labour contract show that producers maximize their profit offering labour contracts in order to settle salaries depending on productivity variations. By acting like this, producers protect their past investments in forming human capital, and can, at the same time, attract the workers owing to a lower average salary only in case they offer contracts according to which salaries permanently adjust with productivity.

Finally, in an uncertain environment, adjusting costs and error risks associated with the changes of prices and salaries are generally higher than those connected with the changes of the amounts. According to such a vision, the normal functioning of the labour market faces a recession that has as a result salaries rigidness when diminishing. According to the classical and monetarist adjusting process, the first link is based upon the idea that unemployed persons compete with employed persons in order to get a job and that such a competition is going to force the last ones to accept salaries diminishing. This idea has been contradicted by the 1970 – 1980s' European unemployment that allowed the emphasizing of two aspects.

The first aspect regards the fact that unemployment is due to a change of the structures of demand and production. As a result, the unemployed persons that come from declining fields possess neither the training nor the experience needed in order to work in expanding fields; consequently, from this point of view, they are not in competition with the employees working in such fields.

The second aspect shows that the prolonging of unemployment's length has an uncertain effect upon employing unemployed persons. The facts are as follows: the longest an individual's unemployment period the less his/her capacity of finding a job.

As a conclusion, the longest the adjusting process, the longest unemployment duration and the least unemployed persons are real competitors of employed persons on labour market. Keynes's conception does not entirely reject the theoretical pertinence of the classical adjusting process that emphasizes real tensions in economy.

Such a process is considered by Keynes's conception as being too uncertain and too long in order to expect an automatic returning to the balance of labour complete use. As a result, the short term is too long and too expensive as regards unemployment demanding the intervening of economic policy.

Finally, the objective of Keynes's strategy is similar with that of the classical strategy of restoring demand at its initial level. This objective of Keynes's theory is more directly and rapidly reached by pushing aggregated demand up owing to a budget and/or expansionist monetary policy. One can notice that such a policy pushed Ca towards CA_0 and restores economy in point A, considering that such a policy is not quite inflationist, restoring the prices only to their previous level.

A recent specialized work considers that the political success of the 80s represents the general success of the control upon public debts, most of the governments considering their inter-temporal budget constraints as an impediment in employing no matter what decisive fiscal policy in order to counteract the deterioration of aggregated demand.

In order to analyze *the adjustment of economy to a shock that affects aggregated offer* we use the graphical representation of figure 2. We start from point A and assume that a shock occurs manifesting through an important increase of the price of certain natural resources in an economy where they are totally imported and represent, at the same time, an energetic need. The immediate consequence of the shock is the obvious increase of real production cost and profits diminishing.

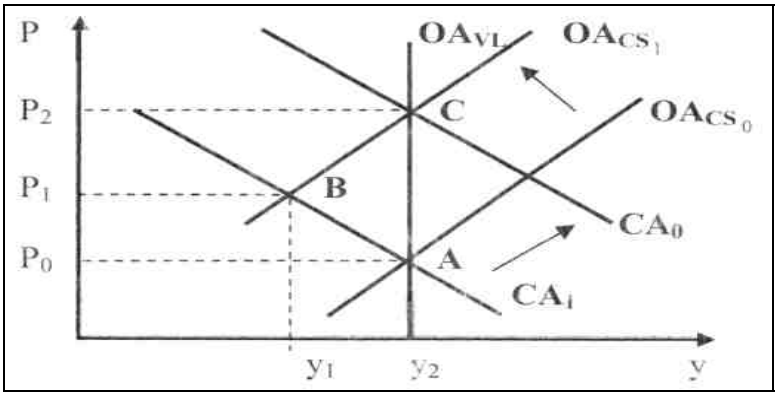

Figure 2. Representation of adjusting to the shocks of aggregated offer

Under such circumstances, for a given price, producers are stimulated to diminish their production; offer curve moves towards left; a new balance is reached in point B, being characterized by a higher general level of the prices and a decreased production situated under the level of labour complete use.

The adjustments to the values of the offer, as in the case of aggregated demand, are analyzed according to the three conceptions. According to the *classical conception* point B in figure 2 is not considered to be a balance point as it only shows the direction economy tends to in case prices are not perfectly flexible. In this point y_1 is smaller than y_2. Unemployment appears on labour market and instantly exerts a pressure regarding the diminution of nominal salaries. Accordingly, salaries diminution compensates the increase of energetic supplies costs, and producers can maintain their offer at its initial level. Consequently, in case the speed of prices adjustment is unlimited and anticipations are rational, on a short term, offer does not move towards left. The shock once appeared, producers, as well as workers, know the extent of the increase of production real costs as well as to what extent nominal salaries should be diminished in order to entirely use labour. According to the *monetarist conception* the anticipations and the flexibility of salaries are not perfect on a short term.

The movement first occurs towards point B. The shock upon offer determines *stagflation* that is the combining of inflation with production decrease. Yet, this effect occurs only temporary. As a matter of fact, in point B there is an unemployment that exerts a pressure in order to decrease nominal salaries; the decrease compensates the increase of energetic supplies costs, and producers increase again the offer of goods and services. Accordingly, the offer moves again towards right, and the general level of prices decreases. As long as production does not allow the complete use of labour, unemployment occurs, salaries diminution takes place, stimulating offer and diminishing prices.

The movement continues until the offer returns to OA_{cs} where complete use is restored. After adjustment, workers' buying capacity decreases, nominal salaries diminish, and the general level of prices returns to the initial one. Under such circumstances, the workers are those who are going to totally bear adjusting cost. They will accept this transitory cost in exchange of maintaining their jobs and their future incomes. *As a conclusion, we can state that the shocks upon offer do not have short term direct effects as economy returns to a general balance of the complete use of labour, the intervening of economic policy not being necessary.*

According to *Keynes's conception* (figure 2), a re-launching policy can move aggregated demand CA_0 to CA_1 in order to reach point C. Although it stresses inflation, production recession and unemployment increase are avoided. One can also notice that in point C and in point A real salaries diminished; the diminishing of the real labour cost occurring owing to increasing the prices accompanied by an unchanged nominal salary. Accordingly, the direct confrontation between producers and employees is avoided through the re-negotiation of nominal salaries with a view of diminishing them; at the same time, the workers will avoid the adjusting period through unemployment. Consequently, the longer the terms associated with the process of classical adjustment, the more advantageous the strategy of re-launching demand.

They accordingly admit the hypothesis that the government adopts the strategy of re-launching the demand in order to compensate the depressive effect of energetic shock, the new balance being situated in point C; yet, this balance tends to be unstable. Such an approach is nor specific to Keynes's theory. Consequently, no matter the initial political reaction to the energetic shock would be, the cost determined by it should be paid in one manner or another, a series of confrontations between producers and employees taking place and accordingly restoring a balance owing to the distribution of cost between the two parties concerned.

A re-distributing strategy of real costs consists in stimulating demand and stopping offer's regress so that a point situated between A and C should be reached, re-launching being compulsorily the responsibility of the government. The mastering of the regress of aggregated offer can determine the diminution of the profit rate envisaged by the producers. Profits and buying capacity regress so each party bears a part of the adjusting cost.

A specific character can be encountered, in the case of offer's shocks, the system of exchange rates, especially of those flexible ones. Such circumstances express the fact that when dealing with a severe shock of the offer, a system with fixed exchange rates can be maintained only in those countries that similarly approach the matter and have compatible points of view regarding the manner they are going to react.

We consider that an *unfavourable shock upon offer* negatively affects the increase, unemployment, and inflation, in contrast with the arbitration of Phillips curve, the instruments of administrating demand not being capable of preventing an offer's shock. Accordingly, when the curve of aggregated offer moves upwards and towards left, the management of demand is not able to intervene neither upon inflation nor upon production. Subsequently, the policies of demand should express a difficult option between letting the shock materialize in an increase of inflation or in a decrease of production and an increase of unemployment.

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